

Internal Revenue Service  
**memorandum**

CC:TL-N-4171-91

Br2:LSMannix

date: JUN 20 1991

to: Deputy Regional Counsel (TL), Western Region CC:W

from: Assistant Chief Counsel (Tax Litigation) CC

subject: [REDACTED]

This responds to your request for advice addressed to the Associate Chief Counsel (Technical) and the Assistant Chief Counsel (Tax Litigation), dated February 21, 1991. This also responds to your supplemental request for advice addressed to the Assistant Chief Counsel (Tax Litigation), dated May 6, 1991. Both cases are presently awaiting trial.

ISSUE

Whether the Commissioner should maintain his position that income assigned from [REDACTED] and [REDACTED], to [REDACTED], under section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), in excess of [REDACTED]'s losses and credits, remains with [REDACTED] notwithstanding that the Commissioner issued a letter ruling to [REDACTED] and [REDACTED] stating that any excess income assigned by [REDACTED] would "spring back" to [REDACTED].

CONCLUSION AND RECOMMENDATION

Any income assigned by [REDACTED] and [REDACTED] to [REDACTED] in excess of [REDACTED]'s losses and credits as finally determined by the Service "springs back" to [REDACTED] and [REDACTED]. The effect of this holding on the cases in the Federal District Court for the District of Alaska and the Tax Court is that [REDACTED] would have no tax liability for either of the years at issue. Therefore, with respect to the District Court case, we recommend that a stipulated judgment be entered in favor of [REDACTED], [REDACTED] receive a refund and the case be dismissed. With respect to the Tax Court case, we recommend that a stipulated decision be entered showing no deficiency.

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FACTS

During [REDACTED]'s taxable years ended [REDACTED], and [REDACTED], [REDACTED] and [REDACTED] assigned income to subsidiaries of [REDACTED] under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) in amounts equal to the amount of the losses and credits originally claimed by [REDACTED] in those years. [REDACTED] agreed to transfer only unaccrued rights to income to a subsidiary, [REDACTED], in which [REDACTED] held common stock and a wholly owned subsidiary of [REDACTED] received voting preferred stock. However, [REDACTED] retained a substantial amount of control over [REDACTED]. [REDACTED] was included in [REDACTED]'s affiliated group and when the assigned income was realized, it was included on the consolidated return of the [REDACTED] affiliated group instead of on the consolidated return of the [REDACTED] affiliated group. [REDACTED] transferred stock of actual operating subsidiaries to a newly formed corporation, [REDACTED], in which [REDACTED] received preferred stock and [REDACTED] received common stock (but over which [REDACTED] retained a substantial amount of control). [REDACTED] and its new subsidiaries were included in [REDACTED]'s affiliated group and when the income was actually generated, it was included on the consolidated return of the [REDACTED] affiliated group instead of on the consolidated return of the [REDACTED] affiliated group.

After the above described transactions were executed, [REDACTED] and [REDACTED] received a letter ruling from the Chief Counsel's Office stating that it would not challenge the assignment of income from [REDACTED] to [REDACTED] and that any income assigned by [REDACTED] to [REDACTED] in excess of [REDACTED]'s losses and credits would "spring back" to [REDACTED] and be reported on its income tax return.

A notice of deficiency was issued to [REDACTED] on [REDACTED], for its taxable years ended [REDACTED], and [REDACTED]. The notice disallowed certain losses and credits claimed by [REDACTED], of which the largest disallowance relates to the valuation of certain timber property. Because the Commissioner disallowed certain losses claimed by [REDACTED] for the years at issue, the income assigned by [REDACTED] and [REDACTED] to [REDACTED] exceeded the amount of [REDACTED]'s redetermined losses. [REDACTED]'s deficiency, as determined by the Commissioner, was calculated on this excess income. Implicit in the notice of deficiency is that the Commissioner left the entire amount of the income assigned by [REDACTED] and [REDACTED] in [REDACTED]'s taxable income notwithstanding the statement in the letter ruling that any excess income would "spring back."

██████████ paid the deficiency for the taxable year ended ██████████, and filed a claim for refund with the Commissioner. The Commissioner disallowed the claim on ██████████, and ██████████ filed a complaint in the United States District Court for the District of Alaska on ██████████. For the taxable year ending ██████████, ██████████ filed a petition in the Tax Court on ██████████.

Neither the complaint filed in district court nor the petition filed in the Tax Court raises the issue of whether the income assigned by ██████████ and ██████████ to ██████████ in excess of the losses redetermined by the Commissioner "springs back" (i.e., is taxable) to ██████████ and ██████████. The only issues raised in the complaint and the petition relate to various deductions claimed by ██████████ and denied by the Commissioner. However, the district court has requested that the government amend its pleadings before ██████████, if it intends to address the "spring back" issue.

Answers to the district court complaint and the Tax Court petition were filed on behalf of the government on ██████████, and ██████████, respectively. No trial dates have been set.

#### DISCUSSION

Prior to 1985, I.R.C. § 1504(a) stated that a corporation was part of an affiliated group that qualified to file consolidated returns if 80% of its voting stock and 80% of each class of its nonvoting stock was held by the common parent of the group or another member of the group the owner of whose stock met the same test. The term "stock" for this purpose did not include nonvoting stock that was limited and preferred as to dividends. As part of the Tax Reform Act of 1984, Congress amended section 1504(a) by stating that the 80% ownership requirement meant ownership of 80% of the voting stock and 80% in value of both the voting and nonvoting stock of the corporation. Tax Reform Act of 1984, Pub. L. No. 98-369, § 60, 98 Stat. 494, 577-579. Congress also stated that for this purpose, the term "stock" does not include stock that is nonvoting, nonconvertible, and limited and preferred as to both dividends and in liquidation.

As part of the Tax Reform Act, Congress also exempted certain corporations and transactions from the new section 1504(a) affiliation rules. One such group was Alaskan Native Corporations ("ANC's"). Section 60(b)(5) of the Act stated:

The amendments made by subsection (a) shall not apply to any Native Corporation established under the Alaskan Native Claims Settlement Act (43 U.S.C. 1601 et seq.) during any taxable year beginning before 1992 or any part thereof

in which such Corporation is subject to the provisions of section 7(h)(1) of such Act (43 U.S.C. 1606(h)(1)).

Although the legislative history to the statute is silent, the purpose of section 60(b)(5) was to allow ANC's to sell their losses to profitable corporations, in a manner similar to the transactions here at issue, thereby benefiting the financially troubled ANC's. The financial incentive to the profitable corporations for entering into the transactions was that their tax liabilities were reduced. However, section 60(b)(5) was not considered sufficient for this purpose and, as part of the Tax Reform Act of 1986, Congress replaced the statute with the following provision:

(A) In the case of a Native Corporation established under the Alaskan Native Claims Settlement Act (43 U.S.C. 1601 et seq.), or a corporation all of whose stock is owned directly by such corporation, during any taxable year (beginning after the effective date of these amendments and before 1992), or any part thereof, in which the Native Corporation is subject to the provisions of section 7(h)(1) of such Act (43 U.S.C. 1606(h)(1))--

(i) the amendment made by subsection (a) [of section 60 of the Tax Reform Act of 1984] shall not apply, and

(ii) the requirements for affiliation under section 1504(a) of the Internal Revenue Code of 1986 before the amendment made by subsection (a) shall be applied solely according to the provisions expressly contained therein, without regard to escrow arrangements, redemption rights, or similar provisions.

(B) Except as provided in subparagraph (C), during the period described in subparagraph (A), no provision of the Internal Revenue Code of 1986 (including sections 269 and 482) or principle of law shall apply to deny the benefit or use of losses incurred or credits earned by a corporation described in subparagraph (A) to the affiliated group of which the Native Corporation is the common parent.

(C) Losses incurred or credits earned by a corporation described in subparagraph (A) shall be subject to the general consolidated return regulations, including the provision relating to separate return limitation years, and to section 382 and 383 of the Internal Revenue Code of 1986.

(D) Losses incurred and credits earned by a corporation which is affiliated with a corporation described in subparagraph (A) shall be treated as having been incurred or

earned in a separate return limitation year, unless the corporation incurring the losses or earning the credits satisfies the affiliation requirements of section 1504(a) without application of subparagraph (A).

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(e)(4), 100 Stat. 2085, 2801. The 1986 amendments are effective as if included in the 1984 Act. Pub. L. No. 99-514, § 1881, 100 Stat. 2914.

The Conference Committee Report to the 1986 amendments states:

The conference agreement also provides that, during the applicable transition period, the affiliation requirements of the consolidated returns provisions will be applied to Alaskan Native Corporations (and their wholly owned subsidiaries), . . . , solely by reference to the express language in those provisions. Thus, eligibility for affiliation in the case of such corporations will be determined solely on the basis of ownership of stock satisfying the 80-percent voting power and 80-percent nonvoting tests, without regard (for example) to the value of the stock owned, to escrow arrangements, voting trusts, redemption or conversion rights, stock warrants or options, convertible debt, liens, or similar arrangements, or to the motive for acquisition of the stock or affiliation.

In addition, with certain specified exceptions, no provision of the Internal Revenue Code or principle of law will be applied to deny the benefit of losses or credits of Native Corporations (or their wholly owned subsidiaries) to the affiliated group of which the corporation is a member or of the specified group of corporations, during the applicable transition period. Thus, in general, the benefit of such losses and credits may not be denied in whole or in part by application of section 269, section 482, the assignment of income doctrine, or any other provision of the Internal Revenue Code or principle of law.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-1, II-843, 1986-3 vol. 4 C.B. 1, 843.<sup>1</sup>

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<sup>1</sup> The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5021, 102 Stat. 3342, 3666-3668, repealed section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) generally for losses or credits which arise after April 26, 1988.

No less than 39 ANC's who were assigned income from one or more profitable corporations under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) have been audited or are presently under audit by the Service. Although other variations exist, many of the transactions were much like either one or the other of the transactions involving [REDACTED] and [REDACTED] at issue here. Approximately 26 letter rulings were issued to taxpayers who engaged in transactions under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986). Of these, approximately 22 contain generally the same "spring back" language that is contained in the letter ruling to [REDACTED] and [REDACTED]. The "spring back" language is not contained in a ruling with a transaction, like the one involving [REDACTED], in which the profitable corporation transferred income producing assets or stock of a subsidiary that contained income producing assets (as opposed to transferring mere rights to unaccrued income) to a subsidiary controlled jointly by it and the ANC.

A substantial portion of the losses claimed by the ANC's, which were used to offset the assigned income, were with respect to timber property. A substantial portion of these claimed losses were or are being disallowed by the Service. Thus, the instant issue--Whether the excess income "springs back" to the profitable corporation--is present in virtually all such cases.

The "spring back" rule was developed in the context of certain transactions executed under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), like the transaction involving [REDACTED] and [REDACTED], in which the profitable corporation's tax rate for the year from which the income was assigned was higher than the ANC's tax rate for the year to which the income was assigned--because the profitable corporation's tax year was pre-Tax Reform Act of 1986 and the ANC's year was post-Tax Reform Act of 1986. In such cases, "tax rate arbitrage" could occur, wherein profitable corporations would attempt to assign excess income to ANC's in order to have the income taxed at a lower rate. Technical determined that the profitable corporation could only assign income up to the amount of the ANC's losses and credits. Any excess income that was assigned to the ANC's would "spring back" to the profitable corporation and be included in its return and taxed at its tax rate.

The specific rule of law upon which the "spring back" rule rests is that section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) only applied to income assigned by a profitable corporation up to the amount of an ANC's losses and credits and, likewise, the

prohibition in section 1804(e)(4) against the use of sections 269 and 482, assignment of income principles or any other principle of law only applied up to the amount of the ANC's losses and credits. Any amount of assigned income in excess of the ANC's losses and credits would be included in the profitable corporation's income pursuant to the normal application of sections 269 and 482, assignment of income principles or other relevant principles of law.

In the transactions at issue and the other ones we have examined, we believe that the excess income is taxable to the profitable corporation. In these transactions, the profitable corporation transferred unaccrued rights to income to a subsidiary controlled jointly by the profitable corporation and the ANC, transferred income producing assets to such a subsidiary or a partnership while retaining an option to repurchase the ANC's stock in the subsidiary, or transferred an asset to such a subsidiary and then purchased an option to purchase the asset at a grossly inflated price. No income assigned by a profitable corporation in excess of the ANC's losses and credits should remain with the ANC in such cases.

In cases where there was merely an assignment of receivables or other assignment that clearly would be impermissible under assignment of income principles, we think that the technically correct answer is that the excess income should "spring back." Furthermore, the Service should treat ANC's that received such assignments but that cannot rely on letter rulings consistently with ANC's that received such assignments and can rely on letter rulings. In this context, it should also be noted that Technical has informed us that the technically correct answer is that the excess income should "spring back" and that it is unwilling to alter any of its letter rulings in order to amend or delete the "spring back" language.

In the cases where there was a transfer of income producing property or stock of a corporation that contained income producing property, like the transaction involving [REDACTED] and [REDACTED], the assignment of income doctrine arguably does not apply. However, strong arguments can be made that other principles of law would apply to require any excess income to "spring back." In virtually all of these transactions, because the profitable corporations retained so much control over the stock transferred to the ANC's and the ANC's only owned the stock for a short period of time, it can be argued that the transfer was a sham and, therefore, section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) does not apply; i.e., in so far as there was income in excess of the ANC's losses assigned to the ANC's. See Gregory v. Helvering, 293 U.S. 465 (1934). It could also be argued that the affiliation rules of section 1504(a) are not met in such

cases, and that, therefore, section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) does not apply, because the ANC's did not have real voting control because of restrictions placed on the stock by the profitable corporations. See Lerner, Antes, Rosen & Finkelstein, Federal Income Taxation of Corporations Filing Consolidated Returns, § 2.03[3], and citations therein. Both arguments could be made with respect to the transaction involving [REDACTED] and [REDACTED] because at the time [REDACTED] received stock in the jointly held subsidiary, [REDACTED] gave [REDACTED] an irrevocable proxy to vote [REDACTED]'s stock as [REDACTED] saw fit, [REDACTED] could not transfer the stock without [REDACTED]'s permission, [REDACTED] had the right to purchase the stock owned by [REDACTED] at a set price at any time and [REDACTED], in fact, purchased the stock from [REDACTED] a short time after the stock was transferred to [REDACTED].

Furthermore, with respect to the transactions we have examined, we think it unreasonable to make a distinction between ANC's that structured their transactions with profitable corporations in such a way as to require a substance over form or sham transaction argument to recast the transaction and ANC's that entered into transactions that were clearly assignments of unaccrued income. The benefits and burdens of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) should be applied consistently in these cases without reference to the form of the transactions.

We acknowledge that some exposure exists with respect to the position that the excess income "springs back" to the profitable corporation. However, legal principles, the Department of Justice's reluctance to defend cases in which the excess income is left with the ANC and Technical's refusal to amend its position or letter rulings leaves us little alternative but to take the position that the excess income "springs back," at least with respect to the transactions we have examined.

It should be noted, however, that there may be certain cases in which it would be difficult to argue assignment of income principles, section 482, or any other principle of law in asserting that any excess income assigned to a particular ANC "springs back." We recommend that you consult with us if you are confronted with such a case.

The effect of this holding on the cases in the District Court of Alaska and the Tax Court is that [REDACTED] would have no tax liability for either of the years at issue. Therefore, with respect to the District Court case, we recommend that a stipulated judgment be entered in favor of [REDACTED], [REDACTED] receive a refund and the case be dismissed. With respect to the

Tax Court case, we recommend that a stipulated decision should be entered showing no deficiency.

This holding also makes it unnecessary to answer your supplemental request for advice, the issue in which assumed that the excess income would remain with [REDACTED].

If you have any questions, please contact Alfred C. Bishop, Jr., Chief, Branch 2, Tax Litigation Division at FTS 566-3520 or Edward S. Cohen, Chief, Branch 2, Corporate Division at FTS 566-3484

Signed: Marlene Gross

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MARLENE GROSS